The following is the Franchise Tax Board's analysis of SB 1233 (Lockyer) as amended September 13, 1997.

SUMMARY OF BILL

This bill would make the following changes to the Personal Income Tax Law (PITL) and the Bank and Corporation Tax Law (B&CTL):

1. Increase the dependent exemption credit by $50 in 1998 and an additional $100 in 1999.

2. Make permanent the capital gains exclusion for home sales in conformity with the federal Taxpayer Relief Act (TRA) of 1997.

3. Adopt enhancements to IRA programs in conformity to the federal Taxpayer Relief Act of 1997.

4. Increase the exemption amounts used in calculating the alternative minimum tax (AMT) for individuals and annually index the exemption amounts.

5. Eliminate an increase in S corporation tax rate by chaptering out provisions in SB 5 (Stats. 1997, Ch. 610).

6. Retain the state deduction for self-employed health insurance at the 25% level.

7. Conform state law to the federal penalty for failure of trustees of medical savings accounts to file the required information return.

Each of these issues will be discussed separately in this analysis.

EFFECTIVE DATE

Unless otherwise stated in this analysis, the provisions of this bill would apply to taxable or income years beginning on or after January 1, 1998.

IMPLEMENTATION CONSIDERATIONS

Unless otherwise stated in this analysis, implementing the provisions of this bill would occur during the department's normal annual system update.

DEPARTMENTAL COSTS

Unless otherwise stated in this analysis, the provisions of this bill would not significantly impact the department's costs.

TAX REVENUE SUMMARY

SB 1233 Amended September 13, 1997 (in millions)				
Provision		1997-8	1998-9	1999-0
1.	Dependent Credit Increases	($95)	($400)	($635)
2.	Capital Gains Home Sales Exclusion	0	($60)	($70)
3.	IRA Conformity	($4)	($14)	($31)
4.	Index AMT Exemption & Phase-Out	($8)	($81)	($85)
5.	Subchapter S Conformity (1/1/97)	($18)	($21)	($22)
6.	Self-Employed Insurance Deduction	($9)	0	0
7.	Medical Savings Account Penalty	--	--	--
	TOTALS	($134)	($576)	($843)

POSITION

Neutral.

Unless otherwise stated in this analysis, the staff's position on the provisions of this bill is neutral. The staff's position is determined by administrative considerations and does not take into account tax policy considerations or revenue impact on the state. However, these issues are discussed in the analysis.

ISSUE #1 - DEPENDENT EXEMPTION CREDIT

SPECIFIC FINDINGS

Existing federal law provides various personal and dependent exemptions subject to certain income limitations. These exemptions are treated as deductions from adjusted gross income (AGI). The exemption deduction amount is indexed annually for inflation and is $2,550 for the 1996 tax year. Exemption deductions begin to phase out at federal AGI levels over specified amounts, which are the same amounts as those for state law noted below.

The federal Taxpayer Relief Act of 1997 provides a child tax credit of $400 for 1998 and $500 for 1999 and each year thereafter for each qualifying child. "Qualifying child" is defined as any individual (1) for whom the taxpayer is allowed the dependent exemption deduction, (2) who is under the age of 17, and (3) who bears the same relationship to the taxpayer as that required under the relationship test for the federal earned income credit. "Qualifying child" does not include individuals who are not citizens or nationals of the United States unless they are a resident of the United States. This child tax credit is phased out for taxpayers with adjusted gross income above specified levels. For taxpayers with three or more qualifying children, the credit is limited to the greater of (1) the excess of regular tax over tentative minimum tax, or (2) the alternative credit amount, as defined. Any credit amount in excess of these limitations, reduced by the amount of alternative minimum tax paid, will be refunded to the taxpayer.

Existing state law provides various exemption credits against tax, including a personal exemption and exemptions for dependents, blind persons, and

individuals 65 or older. Unlike federal law, these exemptions are not deductions from AGI but are credits against tax. The exemption credit amount is indexed annually for inflation as measured by changes in the California Consumer Price Index. The exemption credit amount for the 1996 tax year is $67. To compute exemption credits, the total number of exemptions claimed is multiplied by the exemption credit amount (total number of exemptions x $67 = exemption credit). Exemption credits are not refundable and may not be carried over to future years.

Existing state law provides two limitations on exemption credits:

1. Exemption credits begin to phase out at federal AGI levels over the amounts listed below:

Filing Status	AGI (1996)
Single/Married Filing Separate	$111,695
Head of Household	$167,542
Married Filing Joint	$223,390

2. Exemption credits are limited to the amount by which regular tax before credits exceeds tentative minimum tax (TMT).

This provision would increase the dependent exemption credit amount to $120 for the 1998 taxable year and to $222 beginning in the 1999 taxable year. The increased credit would not be adjusted for inflation for the 1999 taxable year. These increased credit amounts would continue to be subject to the above limitations.

Policy Considerations

This bill would provide tax relief to moderate-level income taxpayers with dependents by providing taxpayers with a qualifying dependent a reduced tax liability as a result of the larger dependent exemption credit.

Increasing the dependent exemption credit and not the blind, senior or personal exemption credits would complicate the preparation of taxpayers' returns. Additionally, creating special exemption amounts for these taxpayers would increase the complexity of instructions for all taxpayers.

Implementation Considerations

This provision would complicate the computation of the total exemption credit. Currently, a taxpayer adds all exemptions and then multiplies by $67 for the total exemption credit. This provision would require a multiple-step process because of the different exemption amount for dependents. This provision could add up to three additional lines to the tax return. Implementing this provision would require additional instructions in already crowded tax booklets and extensive program changes. It also would increase public requests for assistance and taxpayer errors.

FISCAL IMPACT

Departmental Costs

This provision would have estimated first year costs of $1.55 million with estimated ongoing costs of $1.35 million.

It is anticipated that the differing exemption amounts would create increased costs, primarily attributable to additional taxpayer error requiring manual resolution by the department. In addition, the difference is expected to increase phone inquiries from taxpayers.

Tax Revenue Estimate

This provision would result in revenue losses estimated to be as shown in the table below:

SB 1233 Amended September 13, 1997 (in millions)			
Provision	1997-8	1998-9	1999-0
Dependent Credit Increases	($95)	($400)	($635)

Tax Revenue Discussion

Revenue losses from this provision depend on the amount of available tax liabilities that these increases in the dependent exemption credit would reduce or eliminate.

Estimates for this provision were based on the department's Personal Income Tax model simulated to reflect the new credit amounts. Approximately 3 million filers would benefit from this increase.

ISSUE #2 - CAPITAL GAIN HOME SALES EXCLUSION

EFFECTIVE DATE

This provision would apply to the sales or exchanges of homes on or after July 1, 1998.

SPECIFIC FINDINGS

Under present California law and federal law prior to May 7, 1997, no gain is recognized on the sale of a principal residence if a new residence at least equal in cost to the sales price of the old residence is purchased and used by the taxpayer as his or her principal residence within a specified period of time. This replacement period generally begins two years before and ends two years after the sale date of the old residence. The basis of the replacement residence is reduced by the amount of any gain not recognized on the sale of the old residence by reason of this gain rollover rule. Additionally, in general, an individual, on a one-time basis, may exclude from gross income up to $125,000 of gain from the sale or exchange of a principal residence if the taxpayer (1) has attained age 55 before the sale and (2) has owned the property and used it as a principal residence for three or more of the five years preceding the sale. California law provides

that if a taxpayer was a member of the Peace Corps, time served in the Corps, up to 18 months, could be counted toward the three years the taxpayer is required to reside in the residence to qualify for the "once-in-a-lifetime $125,000 exclusion." In addition, brokers considered real estate reporting persons (i.e., escrow companies, lenders, brokers, etc.) are required to report to the Internal Revenue Service the amount of gross proceeds and other amounts in transactions involving real estate (including residences). A copy of the federal return is required to be submitted to the Franchise Tax Board.

Under **current federal law**, a taxpayer generally is able to exclude up to $250,000 ($500,000 if married filing a joint return) of gain realized on the sale or exchange of a principal residence. The exclusion is allowed each time a taxpayer selling a principal residence meets certain eligibility requirements, but generally no more frequently than once every two years (sales occurring before May 7, 1997, are not considered for the two-year rule). Federal law provides that gain would be recognized to the extent of any depreciation allowable with respect to the rental or business use of such principal residence for periods after May 6, 1997. To be eligible for the exclusion, a taxpayer must have owned the residence and occupied it as a principal residence for at least two of the five years prior to the sale or exchange.

The **federal House, Senate, and Conference Committee Reports** state a taxpayer who fails to meet these requirements (use for two out of the last five years and no sale within two years of another sale) by reason of a change of place of employment, health, or other unforeseen circumstances is able to exclude the fraction of the $250,000 ($500,000 if married filing a joint return) equal to the fraction of two years that these requirements are met. This proration rule also is available for any sale occurring within the two year period following enactment of this provision. However, the federal law as enacted would limit the exclusion to the fraction of the taxpayer's realized gain on the sale equal to the fraction of two years that the requirements are met. The Joint Committee staff members have indicated they will recommend a technical change to make the statutory language consistent with the unambiguous intent of Congress. The Internal Revenue Service is expected to apply the law as intended from the date of enactment.

In the case of joint filers not sharing a principal residence, an exclusion of $250,000 is available on a qualifying sale of the principal residence of one of the spouses. Similarly, if a single taxpayer who is otherwise eligible for an exclusion marries someone who has used the exclusion within the two years prior to the marriage, the couple would be allowed a maximum exclusion of $250,000. Once both spouses satisfy the eligibility rules and two years have passed since the last exclusion was allowed to either, the taxpayers may exclude $500,000 of gain on their joint return. Federal law also contains special rules regarding: sale of a remainder interest, cooperative housing corporations (e.g., condominiums), involuntary conversions, and taxpayers residing in nursing homes.

Under **federal law,** the TRA repealed the once-in-a-lifetime exclusion of $125,000 and the rollover of gain from the sale of a principal residence provisions of the Internal Revenue Code. The TRA also modified the reporting requirements of brokers for the sale of the broker's client's principal residences.

This bill anticipates the enactment of SB 5 from the 1997/98 Legislative session. SB 5 would conform California law to the federal exclusion of gain from the sale of a principal residence as outlined above for sales occurring between May 7, 1997, and June 30, 1998. For the sale of a taxpayer's principal residence occurring on or after July 1, 1998, **this bill** would conform California law to federal law as it relates to the exclusion of gain from the sale of a principal residence and the reporting of real estate transactions.

Policy Consideration

Conforming to federal tax law is generally desirable because it is less confusing for the taxpayer. With conformity, the taxpayer is required to know only one set of rules. Conformity also eases the department's administration of the law by utilizing many federal forms and instructions. This bill substantially conforms to changes made by the federal Taxpayer Relief Act of 1997 as it relates to the sale of a principal residence.

FISCAL IMPACT

Tax Revenue Estimate

This provision would result in revenue losses estimated to be as shown in the table below:

SB 1233
Amended September 13, 1997
(in millions)

Provision	1997-8	1998-9	1999-0
Capital Gains Home Sales Exclusion	0	($60)	($70)

Tax Revenue Discussion

Overview

There are about 5.77 million owner occupied residences in California. In any given year, about 450,000 of those residences are sold. Of those sales, about 4%, or 18,000, result in taxable gains. The gains, if any, associated with the remaining 432,000 sales are deferred under the rollover provisions of current law. Of the 5.3 million residences that do not sell, a portion would be sold if the owners were not exposed to taxation on the gain. Since federal law has changed and state law remains the same, a smaller portion of owners would sell (2% in this estimate) and those sales would be taxable.

Discussion

This estimate was prepared in several steps. First, potentially affected taxpayers were divided into three groups: 1) those who sell and report taxable gains under current law (about 18,000 annually); 2) those who sell under current law and roll the gains into a replacement residence (about 430,000 annually), and 3) those who do not sell under current law but would if the built-in gains were not taxed. Of the first group, those who sell under current law and

report taxable gains, a micro analysis of tax returns shows that this provision would exempt about 98% of currently reported gains.

The second group, those who under current law sell and roll the gain into a replacement residence, was estimated to consist of about 432,000 sales annually based on sales reported by the California Association of Realtors adjusted for those with reported gains. The tax impact of denying the rollover provisions to this group and excluding $250,000 (single) and $500,000 (joint) of the gain was estimated from a study of over two million residences that claimed the homeowners exemption and that were linked to tax returns. The assessors' data showed date of purchase and purchase price as well as current (1991) assessed values. Assessed values were adjusted to approximate fair market value by applying house-price indices for the period after Proposition 13. The amount of gain for each residence was estimated by adjusting the basis to take into account acquisition costs (3%), selling costs (6% fee plus 2% as a proxy for last minute spruce ups), and improvements (10% of the difference between purchase and sale price). This provides an estimate of the amount of gain that is embedded in owner occupied residences. The next step was to examine the tax impact on a taxpayer by taxpayer basis of whether the gain would exceed the exclusion amounts. The gain in most cases (423,000 or 98% of sales) would be completely excluded. Of the remaining 9,000 or so residences that have gains in excess of the exclusion amounts, it was assumed that taxpayer behavior would reduce this number by half. For the remaining residences, the tax impact was calculated on a taxpayer by taxpayer basis taking into account overall income and filing status of affected taxpayers.

Of the third group, the 5.3 million residences that do not sell, a small percentage of owners (4% according to a recent federal study) would sell if they were not exposed to taxation on any of the gain. Since federal law has changed and state law remains the same, an even smaller percentage of owners would sell (2% in this estimate) and those sales would be taxable. Since the 4% reported in the federal study represents a build up over a long period of time, for this estimate it was assumed that those sales would take place over a three year period at the rates of 10% (first year), 50% (second year) and 40% (third year). In addition, since these sales would involve state tax consequences, it was assumed that only 2% of those residences would sell over the three-year period. This yields an additional 100,000 residences that would sell and report gains in the first three years of this law being effective. These are residences that would sell and not qualify for the rollover (these sellers would not purchase a qualified replacement since if that were the case the transaction would not be taxable under current law). The average tax impact of these sales was assumed to be similar to the tax consequence of the 18,000 or so sales that are reported under current law. This portion of the revenue estimate reflects the amount of revenue that would be realized if California law were not changed. These sales would be stimulated by the favorable federal tax treatment and would result in an increase in taxable gains for state purposes. By conforming, this revenue would be lost.

ISSUE #3 - IRA PROGRAMS

SPECIFIC FINDINGS

The federal TRA made several changes to the Individual Retirement Account (IRA) rules and created two new kinds of IRAs. This bill would conform to the following:

Roth IRA and Expand Existing IRA

1. Increase in Adjusted Gross Income limitations for Individual Retirement Account contributions for individuals in an employer-sponsored retirement plan and change in "active participation" definition.

Under state and federal laws prior to 1998 tax years, a taxpayer could deduct up to $2,000 per year for contributions made to a "deductible IRA." This amount applies to all individuals or their spouses who were not active participants in an employer-sponsored retirement plan. An individual, or the individual's spouse, who is an active participant in an employer-sponsored retirement plan, may deduct the full $2,000 if the individual's adjusted gross income (AGI) is below certain limits. For married taxpayers filing a joint return the $2,000 is phased-out beginning at an AGI of $40,000, and is completely phased-out at $50,000. For single taxpayers the $2,000 is phased-out between $25,000 and $35,000. For married taxpayers filing a separate return, no IRA deduction is allowable if the individual or the individual's spouse is an active participant in an employer-sponsored retirement plan.

The **TRA** increased the federal "AGI threshold levels" for phasing out the $2,000 IRA deduction and changed the definition of active participation in an employer-sponsored retirement plan. Beginning in 1998, the phase-out limits are increased as follows:

For married taxpayers filing joint

1998	$50,000 - $ 60,000
1999	$51,000 - $ 61,000
2000	$52,000 - $ 62,000
2001	$53,000 - $ 63,000
2002	$54,000 - $ 64,000
2003	$60,000 - $ 70,000
2004	$65,000 - $ 75,000
2005	$70,000 - $ 80,000
2006	$75,000 - $ 85,000
2007 and thereafter	$80,000 - $100,000

For single taxpayers

1998	$30,000 - $40,000
1999	$31,000 - $41,000
2000	$32,000 - $42,000
2001	$33,000 - $43,000
2002	$34,000 - $44,000
2003	$40,000 - $50,000
2004	$45,000 - $55,000
2005 and thereafter	$50,000 - $60,000

No deduction is allowed for married taxpayers filing a separate return if the individual is an active participant in an employer-sponsored retirement plan.

Beginning in 1998, **federal law** provides for a new type of IRA, called a Roth IRA. A Roth IRA differs from other IRAs in that the tax advantages are "backloaded." Contributions to a Roth IRA are not tax deductible. Instead, the IRA earnings (e.g., interest and dividends) are distributed tax free (provided that certain requirements are met). To be treated as a Roth IRA, the account must be designated as such when it is established. The contribution limit of $2,000 per year is coordinated with other IRAs (all IRA contributions in any one year cannot exceed $2,000 in aggregate). A 6% penalty applies to any contribution in excess of $2,000. Unlike other IRAs, an individual may make contributions to a Roth IRA beyond the individual's age of 70½.

Roth IRAs also are subject to AGI limitations. The maximum amount allowed for a Roth IRA contribution is phased out for single taxpayers with AGI between $95,000 and $110,000 and for married taxpayers filing joint with AGI between $150,000 and $160,000. If after applying the phase-out limitations, the computed allowable contribution is less than $200 but more than zero, a $200 contribution is allowed.

Distributions from a Roth IRA are not included in gross income and are not subject to the 10% early withdrawal tax if certain requirements are met. The individual must have held the Roth IRA for a five-year period beginning with the first year in which a contribution was made to the Roth IRA and ending with the end of the fifth year after the contribution. In addition, one of the four following requirements also must be met:

- made on or after the date the individual has obtains age 59½.
- made to a beneficiary (or the individual's estate) on or after the individual death.
- attributable to the individual being disabled.
- a distribution for "qualified first-time home buyer expenses."

Additionally, holders of a Roth IRA do not need to start receiving distributions by the age of 70½, as do holders of other types of IRAs.

If a non-qualified distribution is made from a Roth IRA, the distribution is first treated as made from contributions (that were not deductible). No portion of a nonqualified distribution is treated as attributable to earnings, or is includible in gross income, until the total of all distributions exceeds the amount of total contributions.

Federal law also permits the "rollover" of a non-Roth IRA into a Roth IRA if the taxpayer's AGI for the year does not exceed $100,000 (computed without regard to the rollover distribution) and the taxpayer is not married filing separate. The $2,000 annual contribution limit does not apply to rollovers. The rollover of an ordinary IRA into a Roth IRA requires the taxpayer to report the ordinary IRA distribution in gross income. However, if the ordinary IRA is contributed to the new Roth IRA within 60 days of the distribution the 10% early withdrawal tax

will not apply. If an ordinary IRA is rolled into a Roth IRA before January 1, 1999, the amount that is includible in gross income may be included ratably over a four-year period. Federal law permits a rollover into or between Roth IRAs more than one time a year.

3. Early withdrawal tax does not apply to Individual Retirement Accounts distributions used to pay for qualified education expenses or used for first-time homebuyer expenses.

Federal law provides that the 10% tax on early withdrawals from an IRA does not apply to distributions from an IRA if the taxpayer uses the funds to pay for "qualified higher educational expenses" or for "first-time home buyer expenses." Qualified higher education expenses uses the same definition used for Education IRAs discussed below.

First-time homebuyer withdrawals must be used to buy, build, or rebuild a home within 120 days of distribution. A "first home" is the principal residence of the taxpayer, child, grandchild, or ancestor of the taxpayer. Acquisition costs include any usual or reasonable settlement, financing, or other closing cost. A first-time home buyer is an individual (and spouse, if married) who must not have an ownership interest in a principal residence during the two-year period ending on the date the new home is purchased. The maximum amount of IRA distribution a taxpayer may receive in a lifetime and use for first-time home buyer expenses is $10,000.

4. Individual Retirement Accounts may invest in bullion.

Under **federal law**, the TRA allows IRA assets to be invested in certain platinum coins and in any gold, silver, platinum, or palladium bullion of a fineness equal to or exceeding the minimum fineness required for metals which may be delivered in satisfaction of a regulated futures contract subject to regulation by the Commodity Futures Trading Commission. This provision does not apply unless the bullion is in physical possession of the IRA trustee.

Education IRA

5. Establish Education Individual Retirement Accounts

Under **federal law**, the TRA also created another type of IRA called an Education IRA. Taxpayers with modified AGI below $150,000 ($95,000 for single taxpayers) may contribute up to $500 per year per beneficiary to an Education IRA. Like Roth IRAs, contributions to an Education IRA are not deductible. Earnings on contributions can be distributed to beneficiaries tax free provided the earnings distributed are used to pay for "qualified higher education expenses." The exclusion from the beneficiary's gross income is not available in any year that a Hope credit or Lifetime Learning credit is claimed.

The $500 maximum amount a taxpayer can contribute to an Education IRA is phased-out for married taxpayers with modified AGI between $150,000 and 160,000, and $95,000 and $110,000 for single taxpayers. Modified AGI is the taxpayer's AGI for the year increased by gross income excluded under the federal foreign earned income or other nondomestic earned income

exclusion. After applying the phase-out limitations, if the computed allowable contribution is less than $200 but more than zero, a $200 contribution is allowed. Like other IRAs, a 6% penalty applies to excess contributions. The limitation applies to each contributor; therefore, an individual may be the beneficiary of several different Education IRAs.

Qualified higher education expenses include tuition, books, supplies and equipment required for enrollment or attendance of the designated beneficiary at an eligible educational institution. Qualified higher education expenses include, with certain limitations, room and board. An eligible educational institution is generally an accredited, postsecondary educational institution that is eligible to participate in the Department of Education student aid program.

An Education IRA is a tax-exempt trust and must be designated as such at the time it is created. The trust instrument must provide that:

- no contribution will be accepted by the Education IRA after the beneficiary attains age 18.
- except in the case of rollover contributions, annual contributions to the Education IRA may not exceed $500.
- all contributions must be made in cash.
- the trustee must be either a bank or other person that demonstrates an ability to properly administer the trust.
- no portion of the trust's assets will be invested in life insurance contracts.
- the assets of the trust will not be commingled with other property, except in a common trust or investment fund.
- upon the death of the beneficiary, any trust balance will be distributed to the beneficiary's estate within 30 days.

Any amount in an Education IRA may be rolled over into another Education IRA with the same beneficiary or for the benefit of a member of the original beneficiary's family. This provision allows any residual assets in an Education IRA, after the beneficiary finishes his or her education, to be transferred to another family member. A family member is defined to include ancestors, lineal descendants of the taxpayer and the lineal descendants of the taxpayer's ancestors (e.g., uncles, aunts, nieces and nephews).

Federal law requires the trustee of the Education IRA to file information reports with the Secretary of the Treasury and the beneficiary. Federal law also provides for a penalty for failure to file such reports.
Under the federal conference agreement, any balance remaining in an Education IRA at the time the beneficiary becomes 30 years old must be distributed, and the earnings portion of the distribution will be includible in gross income and subject to the 10% early withdrawal tax because the distribution was not used for education purposes. The law as enacted did not contain this provision.

This bill would conform California law to the recently enacted federal IRA changes discussed above with the following two exceptions:

1. **Under this bill**, Education IRAs would be required to distribute all of the IRA's assets to the beneficiary within 30 days of the date the beneficiary becomes 30 years of age.

2. A technical error was made in the TRA that could encourage immediate distributions from a Roth IRA of rollover amounts. **This bill** corrects that drafting error by requiring a regular IRA rollover to be held in a Roth IRA for five years to avoid a premature withdrawal penalty and to use the ratable income inclusion rules.

Policy Consideration

Conforming to federal tax law is generally desirable because it is less confusing for the taxpayer. With conformity, the taxpayer is required to know only one set of rules. Conformity also eases the department's administration of the law by utilizing many federal forms and instructions. This bill substantially conforms to all parts of the TRA relating to IRAs.

FISCAL IMPACT

Tax Revenue Estimate

This provision would result in revenue losses estimated to be as shown in the table below:

SB 1233
Amended September 13, 1997
$ Millions

IRA Provision	1997-8	1998-9	1999-0	2000-1	2001-2
Roth IRA and Expand Existing IRA	$(3)	$(7)	$(15)	$(45)	$(82)
Education IRA	$(1)	$(7)	$(16)	$(25)	$(37)
TOTAL	**$(4)**	**$(14)**	**$(31)**	**$(70)**	**$(119)**

This estimate does not take into account any change in personal income, employment, or gross state product that may result from enactment of this bill.

Tax Revenue Discussion

Roth IRA and Expand Existing IRA

The following table shows the component parts of the revenue impact of the expanded constraints on contributions to existing IRAs and the introduction of Roth IRAs. The first item, the rollover tax and penalty, shows the amount of tax and penalty that would be levied against existing accounts that are withdrawn and rolled into a Roth IRA under current California law. The second item, recapture rollover tax, shows the amount of tax revenue that would be realized from the amount rolled in line 1 when that amount is included in income and spread over four years. Note that the difference between the totals of lines 1 and 2 is the penalty. The third item, tax on increased rollover, identifies the amount of tax revenue that would be realized

from additional rollovers that would occur if California were to adopt the federal provisions (i.e. allow rollovers in 1998 to be penalty-free and included in income ratably over the next four years). The forth item identifies the revenue loss associated with income excluded from increased deductible contributions and from interest earned on the stock of IRA contributions. Following the table is an overview of the methodology and assumptions underlying these estimates.

Components of IRA Revenue Impact					
	97-8	98-9	99-0	00-1	01-2
1. Rollover Tax & Penalty	($8)	($19)	($1)	($1)	($1)
2. Recapture Rollover Tax	$1	$5	$5	$5	$4
3. Tax on Incr. Rollover	$13	$43	$43	$43	$30
4. Reduced Taxable Income	($9)	($36)	($62)	($92)	($115)
5. Education IRA	($1)	($7)	($16)	($25)	($37)
NET IMPACT	**($4)**	**($14)**	**($31)**	**($70)**	**($119)**

The methodology used for this estimate includes estimating the amount of rollovers that would occur with and without conformity, the amount of increased deductible contributions that would occur under the expanded limitations on amounts, income limits, and spousal contributions, and the amount of otherwise taxable income that would build up in tax exempt IRA accounts. The assumptions used generally mirror the assumptions used by staff of the U.S. Treasury for estimating the nationwide impact of the federal provisions. The main assumptions are that 43% of the current stock of IRA is eligible for rollover into a Roth IRA and that 4.5% of the amount eligible in 1998 will be rolled from an existing IRA into a Roth IRA. For this analysis it is assumed that only 0.45% of eligible accounts would be rolled into a Roth IRA if California does not conform (one tenth the amount that would occur with conformity). This is because the 2.5% penalty and inclusion in 1998 income of the amount rolled would be a significant constraint on the amount rolled. It is assumed that if California were to conform, the amount rolled would approximate the 4.5% of eligible accounts used by the Treasury. Note that under current state law, a rollover of funds from an existing IRA would be treated as an early withdrawal, that is, the amount withdrawn would be subject to a 2.5% penalty and the full amount would be included in income in the year the rollover takes place. Under conformity, the amount rolled generally would not be subject to the penalty, but would be included in income ratably over the next four years. In addition, as indicated by the sizable amounts on line 3, under conformity the amount rolled into Roth IRAs would be substantially larger (ten times as much) as expected under current law. The last item, reduced income, reflects the increase in deductible contributions and the interest earned (but not taxed) on accumulated deposits of both types of IRAs.

Education IRA

The estimate for the education IRA assumes that 50% of projected future college students will be beneficiaries of this plan. Parents may contribute to these accounts from the birth of a child until the child turns 18. Because of the $500 per year cap on contributions,

parents must open these accounts early in their children's lives and make regular contributions to achieve the maximum benefit from the program. Assuming average annual contributions of $450 per account, and an 8% rate of return on investments in these accounts, it was estimated that excluded interest income would be approximately $80 million in 1998, $180 million in 1999, $300 million in 2000, and $450 million in 2001. Assuming an average marginal tax rate on this income of 8%, and converting to fiscal years, produces the revenue losses reported in the above table.

ISSUE #4 - AMT EXEMPTION AMOUNTS

BACKGROUND

In 1987, California enacted legislation that established an AMT in lieu of the previous tax on preference income. The California legislation substantially conformed state law to the AMT provisions in effect at the federal level, which had been adopted as part of the Tax Reform Act of 1986. The AMT at both the federal and state levels was established to ensure that no taxpayers with substantial economic income avoid all tax liability by using exclusions, deductions, and credits (tax preference items).

The California personal income AMT is similar to the federal individual AMT in that neither are indexed. As discussed in "Specific Findings" below, California is projecting a rapid increase in the number of taxpayers who will be impacted by AMT. Similarly, rapid growth also has been projected at the federal level. The Congressional Joint Committee on Taxation and the Office of Tax Analysis in the Treasury Department presented preliminary findings regarding projected growth of the individual AMT at the National Tax Association Spring Symposium.[1] Included in those findings is a projection that federal returns affected by AMT will grow from fewer than one million taxpayers in 1997 to more than 10 million taxpayers in 2007. The findings attribute this rapid growth to lack of indexing.

SPECIFIC FINDINGS

Existing federal law provides a graduated personal income AMT rate of 26% for the first $175,000 of "taxable excess" and 28% of the amount exceeding $175,000 of "taxable excess." "Taxable excess" is defined as the amount of alternative minimum taxable income for the taxable year that exceeds the exemption amount.

Federal law provides a corporate AMT rate of 20% of that portion of the alternative minimum taxable income as exceeds the exemption amount. Exemption amounts are $45,000 for taxpayers filing a joint return or surviving spouses; $33,750 for taxpayers filing single; $22,500 for married taxpayers filing a separate return and estates and trusts; and $40,000 for corporate taxpayers.

Existing state law provides a personal income and corporate AMT rate of 7%. This tax rate is applicable to taxable years beginning on or after January

[1] "The Individual Income Tax AMT: Why It Matters: Washington, E.C., May 19 and 20, 1997.

1, 1996. For taxable years beginning on or after January 1, 1991, and before January 1, 1996, the personal income AMT rate is 8.5%.

California personal income AMT is calculated by increasing regular taxable income by specific tax preference items and making other adjustments for items for which treatment differs under AMT rules. The resulting figure is AMTI, from which an AMT exemption deduction is subtracted in the following amounts: $40,000 for married taxpayers filing joint returns; $30,000 for individuals filing as either single or as a head of household; and $20,000 for married taxpayers filing separate returns. The exemptions are phased out for taxpayers with adjusted gross income over specified amounts. The excess of AMTI over the AMT exemption deduction, multiplied by the 7% AMT rate, is TMT. TMT is compared to regular tax before credits; the amount by which TMT exceeds regular tax before credits is the alternative minimum tax. The PITL provides a variety of credits, some of which may be used to reduce the regular tax below TMT. However, the law specifies that certain credits, including the exemption credits (personal, dependent, blind, and senior), cannot reduce regular tax to an amount less than the TMT. In effect, taxpayers lose some of the value of those credits that may not be carried forward and may not reduce regular tax below TMT.

The AMT exemption deduction was intended to preclude the imposition of the AMT on taxpayers with moderate incomes. However, as a result of the AMT limitation of the exemption credits, in some cases AMT reaches beyond taxpayers with substantial economic income and tax preference items to taxpayers with moderate levels of income and few tax preferences. Unlike regular tax brackets amounts, standard deduction, and exemption credits, the AMT exemption deduction and the exemption phase-out amounts are not indexed. Since the personal income AMT is not indexed and the regular tax system is indexed, the personal income AMT tends to grow faster than regular tax. It is expected that the revenue impact from the personal income AMT will grow by about 20% per year over the next several years.

The lack of indexing for the personal income AMT exemption deduction is projected to affect many low- to moderate-income taxpayers. This is true particularly of head-of-household taxpayers. For 1997, head-of-household taxpayers with adjusted gross income (AGI) between $33,000 and $53,000 who take the standard deduction, because of the AMT limitation of the exemption credits, are allowed the equivalent of fewer than four exemption credits. Taxpayers with AGI between $37,000 and $49,000 are allowed the equivalent of fewer than three exemption credits. By the year 2000, the effect of the lack of indexing for the personal income AMT exemption deduction is projected to affect head-of-household taxpayers who take the standard deduction and have AGI between $41,000 and $53,000 by the equivalent of not allowing any exemption credit. Taxpayers in other filing statuses also will be affected by the AMT limitation of the exemption credits.

Under AB 1233, AMT exemption deductions and exemption phase-out amounts for the 1998 tax year would be increased to the amount that they would have been if they had been indexed since their enactment in 1987. **This bill** also would provide that the AMT deduction and exemption phase-out amounts would continue to be indexed in future years.

Policy Consideration

Indexing the AMT exemption deduction and exemption phase-out amounts would eliminate some lower-income taxpayers from having to pay AMT or having their exemption credits limited.

FISCAL IMPACT

Tax Revenue Estimate

This provision would result in revenue losses estimated to be as shown in the table below:

SB 1233 Amended September 13, 1997 (in millions)			
Provision	1997-8	1998-9	1999-0
Increase AMT Exemption & Phase-Out	($8)	($81)	($85)

Tax Revenue Discussion

Revenue losses from this provision were based on tax data simulations providing for indexing of exclusion amounts and adjusted gross income thresholds for phase-out purposes. These changes resulted in reduced AMT liabilities and greater use of tax credits which are reflected in the estimates.

ISSUE #5 – S CORPORATION RATE

SPECIFIC FINDINGS

Under existing federal law, an S corporation is a small corporation (limited to a maximum of 35 shareholders) that receives tax advantages similar to a partnership (pass-through entity) while benefiting from the corporate characteristic of limited liability. The S corporation itself owes no corporate tax while the shareholders report their distributive share of corporate income as though they earned it individually.

Existing state law generally conforms to the federal provisions except that California imposes a tax rate of 1.5% on S corporation income prior to the income's "pass-through" to shareholders.

This bill anticipates the enactment of SB 5 from the 1997/98 Legislative session. If enacted, SB 5 would increase the S corporation tax from 1.5% to 1.6% for income years beginning on or after January 1, 1997, 1.65% for income years beginning on or after January 1, 1998, 1.7% for income years beginning on or after January 1, 1999, and 1.6% for income years beginning on or after January 1, 2000, and thereafter. This bill would make a nonsubstantive technical change to this section as it read on January 1, 1997. It is anticipated that SB 5 will be chaptered before this bill; therefore, this bill would chapter out the SB 5 change that would have increased the S corporation tax rate.

FISCAL IMPACT

Tax Revenue Estimate

This provision would result in revenue losses estimated to be as shown in the table below:

SB 1233 Amended September 13, 1997 (in millions)			
Provision	1997-8	1998-9	1999-0
Subchapter S Conformity	($18)	($21)	($22)

Tax Revenue Discussion

The losses noted above are the result of reducing the rate on Subchapter S corporation income from the amounts proposed in SB 5.

6. DEDUCTION OF HEALTH INSURANCE COSTS FOR SELF-EMPLOYED INDIVIDUALS

SPECIFIC FINDINGS

Existing federal law provides that a self-employed individual (or a partner or a more than 2% shareholder of an S corporation) can deduct as a business expense a percentage of the amount paid during the tax year for health insurance on the taxpayer and the taxpayer's spouse and dependents. The allowable percentage to 40% and increases as follows:

45% in 1998 and 1999;
50% in 2000 and 2001;
60% in 2002;
80% in 2003 through 2005;
90% in 2006;
100% in 2007 and thereafter.

Existing California law is conformed to the 1993 federal self-employed health deduction amount of 25%.

This bill would correct a technical error contained in Senate Bill 455 (date change conformity). SB 455 would provide language to retain the state deduction for self-employed health insurance at the 25% level by providing that the federal increased deduction percentages for self-employed health insurance does not apply. However, the reference to the Internal Revenue Code (IRC) section contained in SB 455 is incorrect. This bill would make the same changes as those contained in SB 455, but would reference the correct IRC section. However, if this bill is enacted after SB 455, thereby chaptering out the changes to the deduction for self-employed health insurance made by SB 455, this bill would have the effect of making the 40% federal rate apply for 1997 and the 25% rate apply again beginning in 1998.

Policy Consideration

This bill and Senate Bill 455 are not double joined, yet would both make changes to the same law sections. The changes to these law sections proposed by SB 455 would apply to taxable or income years

beginning on or after January 1, 1997, and the changes proposed by this bill would apply to taxable or income years beginning on or after January 1, 1998. If both bills are enacted and this bill is enacted after SB 455, this bill would chapter out the self-employed insurance provisions contained in SB 455. However, other provisions of SB 455 would conform California law to the 1997 IRC. Thus, since the modifications contained in SB 455 would be chaptered out, state law would be fully conformed to federal law for 1997 taxable and income years with regards to the self-employed insurance provisions discussed above.

FISCAL IMPACT

Tax Revenue Estimate

This provision would result in revenue losses estimated to be as shown in the table below:

SB 1233 Amended September 13, 1997 (in millions)			
Provision	1997-8	1998-9	1999-0
Self-Employed Insurance Deduction	($9)	0	0

Tax Revenue Discussion

This provision would not impact the state's income tax revenue (provided Senate Bill 455 is not enacted and thus, does not change the date of California conformity to federal law) because it would retain existing law provisions for the self-employed insurance.

However, if both this bill and SB 455 are enacted and this bill is enacted after SB 455, the self-employed insurance provisions contained in this bill would chapter out the changes made to those provisions contained in SB 455. The result of the enactment of the date change conformity by SB 455 and the chaptering out of the self-employed insurance provisions of SB 455 would be as shown in revenue estimate above.

7. MEDICAL SAVINGS ACCOUNTS INFORMATIONAL RETURN PENALTY

SPECIFIC FINDINGS

Under federal and state law, persons engaged in a trade or business generally are required to report certain activities with third parties on information returns to the Internal Revenue Service (IRS). Information returns include but are not limited to the payment or receipt of interest, receipt of services, the payment of rent, royalties, salaries or wages, and sale of partnership interest. Generally, the third party identified in the information return must receive a copy of the return. The information return must contain pertinent information regarding the person filing the return and certain information relating to the third party (e.g., amount paid or received and the third party's taxpayer identification number).

Federal and state law generally provides for penalties for failing to file the information returns. Generally, the penalty is $50 for each return that either is not filed or is filed incorrectly. The maximum penalty per taxpayer is $250,000 per calendar year.

Under current **California law,** the department may request from the return filer copies of several different information returns filed by a taxpayer with the IRS.

Senate Bill 38 (Stats 1996, Ch. 954) conformed California law to the federal medical savings account (MSA) deduction, operative for years beginning on or after January 1, 1997. However, SB 38 did not contain language to conform to the penalty for failure of trustees of medical savings accounts to file the required information return.

This bill would conform to federal law by providing a $50 penalty for each report not filed with the FTB by the trustee of the MSA.

Policy Consideration

This bill and Senate Bill 455 are not double joined, yet would both make changes to the same law sections. The changes to these law sections proposed by SB 455 would apply to taxable or income years beginning on or after January 1, 1997, and the changes proposed by this bill would apply to taxable or income years beginning on or after January 1, 1998. If both bills are enacted and this bill is enacted after SB 455, this bill would chapter out the medical savings account provisions contained in SB 455. However, other provisions of SB 455 would conform California law to the 1997 IRC. Thus, since the modifications contained in SB 455 would be chaptered out, state law would be fully conformed to federal law for 1997 taxable and income years with regards to the medical savings account provisions discussed above.

FISCAL IMPACT

Tax Revenue Estimate

This provision would result in revenue losses estimated to be as shown in the table below:

SB 1233 Amended September 13, 1997 (in millions)			
Provision	1997-8	1998-9	1999-0
Medical Savings Account Penalty	--	--	--

Tax Revenue Discussion

This provision would not impact the state's income tax revenue because the changes to the medical savings accounts provisions would affect only penalties, which are not a factor in determining the state's tax revenue.